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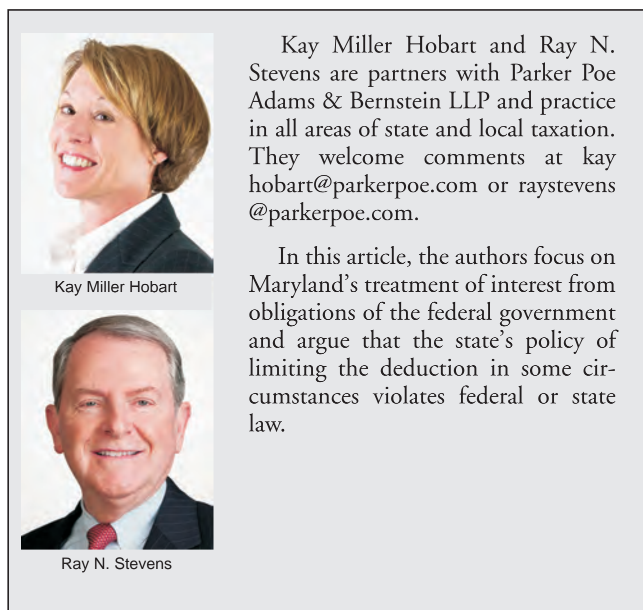
Does Maryland Have Another *Kraft* Problem?

by Kay Miller Hobart and Ray N. Stevens



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In this article, the authors focus on Maryland's treatment of interest from obligations of the federal government and argue that the state's policy of limiting the deduction in some circumstances violates federal or state law.

"We learn from history that we learn nothing from history."

— George Bernard Shaw,
paraphrasing Wilhelm Friedrich Hegel

The seminal case establishing the doctrine of intergovernmental tax immunity involved Maryland's efforts to tax the Bank of the United States. In *McCulloch v. Maryland*, 17 U.S. 316 (1819), the U.S. Supreme Court struck down the tax as repugnant to the supremacy clause of the U.S. Constitution. As a result of that decision, states may not impose taxes that discriminate against obligations of the United States. Almost 200 years later, Maryland's tax policy still impermissibly discriminates against federal obligations.[1]

Comptroller Limits Subtraction Modifications In Loss Years

Like many states, the computation of Maryland taxable income begins with federal taxable income.[2] Also similar to many states, Maryland then requires additions to and deductions from federal taxable income, called "addition modifications" and "subtraction modifications," to arrive at Maryland taxable income.[3] One of the required deductions, or subtraction modifications, is interest from U.S. obligations.[4] Other required subtraction modifications include a deduction for foreign dividends.[5]

In *Westinghouse Electric Corp. v. Comptroller*, 1984 WL 2886 (Md. 1984), the Maryland Tax Court confronted the question of what happens when a Maryland subtraction reduces a positive federal taxable income to a negative number (a Maryland loss).

Westinghouse had properly subtracted dividend income from federal taxable income. The result, despite a positive federal taxable income (the base required by Maryland), was a negative number (a loss) at the Maryland level. Westinghouse attempted to carry the loss forward to offset Maryland taxable income in the next succeeding tax year. The court held that Westinghouse was not permitted to carry over the loss to the succeeding year because it was "attempting to create a NOL deduction where none existed." The court concluded that "there is no Maryland statutory justification for a taxpayer to create a NOL carryover."

Thus, in years that a net subtraction modification (when subtraction modifications exceed addition modifications)[6] either creates or increases a net operating loss, Maryland prohibits a carryforward of that loss. Because the created or increased loss cannot be used to reduce income in future years, the taxpayer loses the benefit of that loss (and of the subtraction modification creating that loss). Before 2001 Maryland applied that policy to all subtraction modifications.

Limitation on Subtraction Modification for Foreign Dividends Is Unconstitutional

In *Kraft General Foods Inc. v. Comptroller*, No. 98-IN-OO-0353 (Md. T.C. 2001), the Maryland Tax Court held that Maryland's policy limiting the subtraction modification for foreign dividends violated the foreign commerce clause of the U.S. Constitution.

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[1]The authors are representing a taxpayer challenging that policy before the Maryland Tax Court.

[2]Md. Code Ann. Tax-Gen. section 10-304.

[3]Md. Code Ann. Tax-Gen. sections 10-305 and 10-307.

[4]Md. Code Ann. Tax-Gen. section 10-307(f).

[5]Md. Code Ann. Tax-Gen. section 10-307(d).

[6]Maryland refers to that as a "negative net addition modification." *See* Maryland Administrative Release No. 18.

Kraft had accumulated, but not deducted, foreign dividends and claimed a subtraction for that amount by using an NOL carryforward. The comptroller disallowed the carryforward subtraction based on its "consistent, long standing, unbroken policy that a corporation is not permitted to utilize a subtraction modification to increase its net operating loss carryforward to an amount in excess of its federal net operating loss." The taxpayer argued that that policy unconstitutionally discriminated against foreign-source dividends in favor of dividends from domestic corporations.

The Maryland Tax Court said that because domestic-source dividends are deducted from federal taxable income, the starting point in calculating Maryland taxable income will never include those dividends. The court said that if the taxpayer incurs a loss, the entire loss can be carried forward to future years for Maryland tax purposes.

By contrast, foreign-source dividends are in federal taxable income. Maryland generally allows those dividends to be deducted in the year they are received but, as explained, if the deduction creates or increases a loss, the amount of the created or increased loss cannot be carried forward. After explaining that, the Tax Court said, "This is true of all subtraction modifications, not solely the one at issue here."

In analyzing the comptroller's policy in *Kraft*, the court said:

> Thus, this Court looks beyond the language of the subtraction modification (which does correct the unequal treatment of foreign source dividends caused by the federal tax code) to the Respondent's scheme of taxation as pertaining to net operating losses. That scheme treats two taxpayers (one receiving domestic source dividends and the other foreign source dividends) in identical situations (in the years following a loss year) differently. In every year following a loss year, a corporation will always get the benefit of the federal deduction for domestic source dividends received in the loss year while the Maryland subtraction modification for foreign source dividends received in the loss year will be lost.

The court held that disparate treatment improperly favored domestic dividends over foreign dividends and therefore violated the foreign commerce clause of the U.S. Constitution.[7]

Following *Kraft*, the comptroller's office changed its policy and allowed a subtraction for foreign dividends to be carried forward. Administrative Release No. 18 explains the rationale for that shift:

> The *Kraft* decision held that while Maryland's legislature had taken steps to allow companies to subtract foreign source dividends and therefore give equal treatment to domestic and foreign source dividends as required by the Commerce Clause of the U.S. Constitution, that equality was lost in an NOL year when subtraction modifications exceeded addition modifications. Accordingly, when the benefit of subtracting foreign source dividends is lost through a negative Net Addition Modification calculation, that foreign source dividend subtraction is now used to adjust the Loss Year NOL (or create [a foreign dividend subtraction carryforward]).

Thus, after *Kraft*, the comptroller deviated from its consistent, long-standing policy of not allowing a net subtraction modification (a negative net addition modification) to create or increase an NOL. By adopting *Kraft* in Administrative Release No. 18, the comptroller recognized that circumstances exist in which a subtraction modification could either increase or create a Maryland NOL carryforward different from the federal amount.[8]

Comptroller's Policy Impermissibly Discriminates Against Federal Obligations

After *Kraft*, Maryland failed to change its policy on other subtraction modifications and continued to limit the deduction in loss years. Thus, when a net subtraction modification includes interest from federal obligations and creates or increases a loss, a taxpayer holding federal bonds does not receive the full benefit of the deduction.

An example demonstrates application of the policy. Assume federal taxable income is $100, the starting point for computing Maryland taxable income. A taxpayer has $10 in addition modifications and $200 in subtraction modifications, of which $180 is federal interest. The net of the addition and subtraction modifications is negative $190. Subtracting $190 from federal taxable income of $100 creates a loss of $90. Under even the most conservative "ordering rule," at least $70 of the loss is attributable to

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[7]Two other states have addressed claims that the treatment of foreign dividends in calculating NOLs and any corresponding carryforwards violates the foreign commerce clause. Most recently, the Indiana Supreme Court summarily concluded that Caterpillar failed to carry its burden to overcome the statute's presumption of constitutionality. *Indiana Dep't of Revenue v. Caterpillar Inc.*, No. 49S10-1402-TA-79 (Ind. 2014). However, the court provided no substantive analysis, saying in a footnote that a contrary decision would produce millions of dollars in lost revenue. In *Colgate-Palmolive Co. v. Florida Dep't of Revenue*, 988 So.2d 1212 (Fla. Dist. App. Ct. 2008), the court held Florida's limitation of NOL carryovers to federal net losses did not facially discriminate against foreign dividends. The statutory scheme **(Footnote continued in next column.)** did not favor domestic dividends over foreign dividends because Florida law allows a subtraction for foreign dividends and allows any net losses resulting from the subtraction to be carried over to future years.

[8]Administrative Release No. 18 recognizes other circumstances that permit a Maryland NOL different from the federal NOL. For example, Maryland's decoupling from federal depreciation allows a Maryland taxpayer to increase a federal NOL or create a "Maryland only" NOL.

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federal interest.[9] Maryland does not permit the $90 loss (including the $70) to be carried over to the next tax year. The benefit of $90 of the subtraction modification for federal interest is therefore lost.

No limitation applies to Maryland bonds, however. Because interest on Maryland bonds is excluded from federal taxable income, a taxpayer holding Maryland bonds always enjoys the full benefit of the deduction for Maryland interest.[10]

Comptroller's Policy Violates the Supremacy Clause

Under *McCulloch*, a state cannot impose a tax on the federal government. A long-standing corollary prohibits taxes that discriminate against federal obligations.[11] The test for improper discrimination is straightforward: "A state tax that imposes a greater burden on holders of federal property than on holders of similar state property impermissibly discriminates against federal obligations."[12]

For the reasons articulated in *Kraft*, the comptroller's scheme of taxation for NOLs discriminates against interest from federal obligations. By limiting the deduction for federal interest in loss years while allowing the full benefit of interest from Maryland obligations, the comptroller's policy discriminates against federal obligations in favor of bonds issued by Maryland.

The Maryland Tax Court invalidated the comptroller's discriminatory policy when the policy created the same burden against foreign commerce it now seeks to impose against the federal borrowing power. If the operation and effect of the comptroller's policy in *Kraft* was discriminatory against foreign-source dividend income (which it was), that policy continues to be discriminatory when applied in a similar manner to federal interest income. The comptroller's policy should be found to violate the supremacy clause under the principles announced in *McCulloch*.

Comptroller's Policy Violates Federal and State Law

Reflecting the principles announced in *McCulloch*, 31 U.S.C. section 3124 exempts federal interest from state taxation. That statute not only prohibits a state from taxing interest from federal obligations, but also precludes all forms of taxation that require federal interest "to be considered in computing a tax."

The protection afforded by 31 U.S.C. section 3124 is sweeping. The U.S. Supreme Court has held that "the tax is barred regardless of its form if federal obligations must be considered, either directly or indirectly, in computing the tax."[13] Maryland's policy defies that prohibition in two ways: by taxing exempt federal interest and requiring interest income to be considered in computing the tax.

Finally, the policy runs afoul of Maryland's own statute requiring a deduction for federal interest in Md. Code Ann. Tax-Gen. section 10-307(f). Under that provision, interest from federal obligations, "to the extent included in federal taxable income," must be subtracted from federal taxable income. By not permitting the full amount of the deduction for federal interest in loss years, Maryland's policy contravenes the plain language of the statute.

Conclusion

Perhaps George Bernard Shaw's quip that we learn nothing from history seems a bit pessimistic. But there is strong evidence in Maryland to support Shaw's view. Almost 200 years ago in *McCulloch*, the U.S. Supreme Court prohibited taxation of the federal government and in later decisions invalidated taxes that discriminated against the federal government. More than a decade ago, in *Kraft*, the Maryland Tax Court prohibited discrimination against foreign dividends resulting from the denial of subtraction carryforwards, holding that carryforwards were required to ensure the equality of treatment guaranteed by law. The fact that discrimination against exempt federal interest still lingers in Maryland breeds pessimism.

Pessimism should never carry the day, however. A more optimistic note must be sounded. Perhaps the comptroller will observe that history has provided significantly similar tax events and that the allowance of carryforwards of undeducted federal interest is required. Doing so will unseat Shaw and permit a more humorous philosopher to remind us that "history doesn't repeat itself, but it does rhyme."[14] ✰

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[9]In other words, assume that both the $100 federal taxable income and the $10 addition modification are first offset with the federal interest and not the other subtraction modifications, thereby "using" $110 of the total deduction for federal interest. Maryland has not adopted that ordering rule, however, and it is contrary to the procedure developed for foreign dividends following *Kraft* in Administrative Release No. 18.

[10]Just as with domestic-source dividends, interest from Maryland obligations is deducted from federal taxable income, so the starting point in calculating Maryland taxable income will never include that interest income. By contrast, interest from federal obligations, like foreign-source dividends, is in federal taxable income.

[11]*Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983).

[12]*Id.*

[13]*American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 862 (1983).

[14]Commonly attributed to Mark Twain, though there is no evidence of his actually saying it. (Jeff Sommer, "Funny, But I've Heard This Market Song Before," *The New York Times*, June 18, 2011). One possible source for the attribution is "A Said Poem" by John Robert Colombo, which contains the line "'History never repeats itself, but it rhymes,' said Mark Twain."